

Premera Blue Cross

Discussion Materials: Allocation
Between Washington and Alaska

August 1, 2003

The Blackstone Group®

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OVERVIEW

- This draft report contains Blackstone's preliminary analysis on the appropriate split of proceeds between Washington and Alaska in the proposed conversion of Premera Blue Cross.
- Blackstone has based its analysis on historical and projected financial information relating to Premera's Washington and Alaska operations, as provided by Premera management.
- Blackstone has also analyzed a "Sensitivity Case" which made certain adjustments to the assumptions in management's financial forecast. A comparison of the two cases is included on pages 2 - 3.
- Blackstone analyzed the relative contribution of the Washington and Alaska operations on both a historical and projected basis for certain operating and financial metrics including members, revenues, underwriting margin, contribution margin, operating income, and net income.
- The operating income and net income metrics include several allocations of fixed costs and therefore may be less reliable indicators of the allocation of value. The net income metrics also include allocations of investment income. Blackstone has placed greater emphasis on members, revenues, underwriting margin and contribution margin given the lack of agreement among the Washington and Alaska actuaries regarding the allocation of administrative expenses between the Washington and Alaska operations. Blackstone would note that the actuaries have indicated that the historical allocation of operating expenses PMPM to Alaska could range from [] (representing a range of approximately [] PMPM) in 2001 and from [] (representing a range of approximately [] PMPM) in 2002.
- Blackstone also considered certain qualitative factors in interpreting the results of the various contribution analyses. These factors have been discussed in due diligence sessions with management and are summarized on page 5.
- For purposes of this analysis, based on legal guidance from Cantilo & Bennett, Blackstone has assumed that Premera Blue Cross Washington ("PBC-WA") and LifeWise Washington are included in Washington's share and Premera Blue Cross Alaska ("PBC-AK") is included in Alaska's share. The following entities have been excluded from the relative contribution analysis: LifeWise Oregon, NorthStar, WAGS, States West, LifeWise Health Plan of Arizona (f.k.a. MSC Life), and Calypso Healthcare Solutions.
- Based on our analysis of the relative contributions of the Alaska and Washington operations as well as a consideration of the qualitative factors, Blackstone's preliminary range for Washington's share of the total conversion proceeds is 83% - 89%.

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COMPARISON OF PROJECTION CASES

(\$ in thousands)

	Actual			Budget 2003	Projected				CAGR '00 – '02	CAGR '02 – '07	Cumulative '03 – '07
	2000	2001	2002		2004	2005	2006	2007			
Insured Members											
Management Case	1,116,625	1,132,735	1,104,900						(0.5%)		
Sensitivity Case	1,116,625	1,132,735	1,104,900						(0.5)		
Revenue											
Management Case	\$1,998,751	\$2,426,808	\$2,617,749						14.4%		
Sensitivity Case	1,998,751	2,426,808	2,617,749						14.4		
Underwriting Margin											
Management Case	\$333,680	\$420,131	\$467,822						18.4%		
Sensitivity Case	333,680	420,131	467,822						18.4		
Contribution Margin											
Management Case	\$258,829	\$324,902	\$364,784						18.7%		
Sensitivity Case	258,829	324,902	364,784						18.7		
Operating Income											
Management Case	\$13,721	\$27,948	\$35,995						62.0%		
Sensitivity Case	13,721	27,948	35,995						62.0		
Net Income ⁽¹⁾											
Management Case	\$37,979	\$51,157	\$51,948						17.0%		
Sensitivity Case	37,979	51,157	51,948						17.0		

⁽¹⁾ 2002 Net Income excludes \$34.1 million in investment impairment charges to Premera Blue Cross and \$5.6 million in conversion costs. 2003 Net Income excludes \$14.0 million in conversion costs.

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COMPARISON OF PROJECTION CASES (CONT'D)

(\$ in thousands)

	Actual			Budget	Projected				CAGR	CAGR
	2000	2001	2002	2003	2004	2005	2006	2007	'00 – '02	'02 – '07
Revenue Growth										
Management Case	–	21.4%	7.9%						–	–
Sensitivity Case	–	21.4	7.9						–	–
Medical Loss Ratio										
Management Case	84.9%	84.5%	84.1%						–	–
Sensitivity Case	84.9	84.5	84.1						–	–
Operating Expenses / Revenue										
Management Case	12.3%	12.2%	12.6%						–	–
Sensitivity Case	12.3	12.2	12.6						–	–
Operating Income Margin										
Management Case	0.7%	1.2%	1.4%						–	–
Sensitivity Case	0.7	1.2	1.4						–	–
Net Income Margin ⁽¹⁾										
Management Case	1.9%	2.1%	2.0%						–	–
Sensitivity Case	1.9	2.1	2.0						–	–
Net Income Growth ⁽¹⁾										
Management Case	–	34.7%	1.5%						–	–
Sensitivity Case	–	34.7	1.5						–	–
Revenue PMPM										
Management Case	\$153.56	\$172.80	\$192.29						11.9%	
Sensitivity Case	153.56	172.80	192.29						11.9	
Healthcare PMPM										
Management Case	\$130.43	\$145.97	\$161.69						11.3%	
Sensitivity Case	130.43	145.97	161.69						11.3	
Operating Expense PMPM										
Management Case	\$15.79	\$17.09	\$18.89						9.4%	
Sensitivity Case	15.79	17.09	18.89						9.4	

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⁽¹⁾ 2002 Net Income excludes \$34.1 million in investment impairment charges to Premera Blue Cross and \$5.6 million in conversion costs. 2003 Net Income excludes \$14.0 million in conversion costs.

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WASHINGTON IMPLIED SHARE OF CONVERSION PROCEEDS⁽¹⁾

The table below outlines Washington's implied share of the conversion proceeds under each of the operating and financial metrics. It should be noted that operating income and net income figures include several allocations of fixed costs,⁽²⁾ and therefore may be less reliable indicators of the allocation of value.

		Actual		Budget		Projected			Cumulative	Cumulative
	2000	2001	2002	2003	2004	2005	2006	2007	Historical	Projected
									'00 – '02	'03 – '07
Insured Members										
Management Case	90.6%	89.4%	88.8%	88.4%					89.6%	
Sensitivity Case	90.6	89.4	88.8	88.6					89.6	
Revenue										
Management Case	89.3%	88.1%	86.8%	86.8%					88.0%	
Sensitivity Case	89.3	88.1	86.8	87.3					88.0	
Underwriting Margin										
Management Case	88.2%	88.8%	86.1%	89.4%					87.6%	
Sensitivity Case	88.2	88.8	86.1	89.1					87.6	
Contribution Margin										
Management Case	88.0%	88.9%	85.7%	90.1%					87.4%	
Sensitivity Case	88.0	88.9	85.7	89.7					87.4	
Operating Income										
Management Case	13.0%	48.2%	26.5%	75.9%					31.1%	
Sensitivity Case	32.4	59.6	31.0	69.5					41.3	
Net Income										
Management Case	63.7%	71.0%	54.3%	82.2%					62.8%	
Sensitivity Case	71.8	76.2	56.7	78.4					67.8	

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⁽¹⁾ Includes Premera Blue Cross Washington and LifeWise Washington.

⁽²⁾ Net income metrics also include allocations of investment income.

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VALUATION CONSIDERATIONS

Blackstone notes the following considerations may affect the potential allocation of value between the Washington and Alaska operations.

- As a stand-alone entity, PBC-AK may lack economies of scale.
 - With respect to relative contribution under Premera management's projections between the Washington (including PBC-WA and LifeWise Washington) and the Alaska (PBC-AK) operations, the Alaska operations represents only 13.2% of revenue, [REDACTED] of underwriting margin and [REDACTED] of contribution margin in 2003.
 - Under Premera management's projections, PBC-AK will only have approximately 112,000 members at year-end 2003.
 - Premera management believes that PBC-AK already has a market share of 38% in the insured market of Alaska (80+% of insured market excluding state employees).
 - The Alaska operations had a total population of approximately 640,000 in 2001 according to the U.S. Census Bureau and no contiguous areas in which to expand operations in order to gain scale.
 - Alaska may have less flexibility to access the capital markets.
- The Company noted that the Alaska operations are not a major growth opportunity and that winning the government account is the only significant opportunity for growth. Furthermore, the Company noted that it was not willing to lose money in trying to win the government account in Alaska.
- Most contracting in Alaska is on a fee-for-service basis with some PPO business, as managed care has never really gained widespread acceptance.
- The Company believes that it can grow its operations and market share in Western Washington. The Company recently was awarded the Microsoft account due largely to the strength of its Dimensions platform, its status as a local plan and its ability to service National accounts through the BlueCard program. The Company would like to grow its National Accounts business and sees Weyerhaeuser, Starbucks, Nordstrom and Washington Mutual as large corporations headquartered in Western Washington that could be potential customers.
- From 2002 – 2007, under management's case, PBC-AK is only forecasting a [REDACTED] compound annual growth rate in net income, while Washington⁽¹⁾ is forecasting a net income CAGR from 2002 – 2007 of [REDACTED]

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⁽¹⁾ Includes PBC-WA and LifeWise Washington combined results of \$22.5 million and [REDACTED] million of net income in 2002 and 2007, respectively.